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IRS MODERNIZATION

Long-term Effort Under Way, but Significant Challenges Remain

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Statement

IRS Modernization: Long-term Effort Under Way, but Significant Challenges Remain

Mr. Chairman and Members of the Committees:

We are pleased to be here today to discuss the Internal Revenue Service's (IRS) modernization progress as we approach the second anniversary of the passage of the IRS Restructuring and Reform Act of 1998 (Restructuring Act).[1] The Restructuring Act signaled strong congressional concern that IRS had been overemphasizing revenue production at the expense of fairness and consideration of taxpayer interests. To deal with this concern, the Restructuring Act mandated specific taxpayer protections as well as more fundamental changes to IRS' mission and organizational structure.

Building on the direction set forth in the Restructuring Act, Commissioner Rossotti established a new mission statement and supporting strategic goals,[2] then embarked on a multifaceted, integrated modernization effort that encompasses changes to IRS' organizational structure, business practices, performance management system, and information systems. As we have said in the past, this modernization effort, more so than past efforts, clearly has the potential to provide improved service to taxpayers and to address IRS' long-standing management weaknesses.[3]

Our statement today discusses IRS' progress in implementing the modernization effort and the challenges that lie ahead. It is based on our past work on IRS management and operations. Specifically, our statement makes the following three points:

- IRS is as challenged an agency today as it was almost 2 years ago when the Restructuring Act was passed. IRS continues to face serious operational issues in its two key mission areas—enforcement and customer service. For example, deficiencies in controls to properly manage billions of dollars in unpaid tax assessments have resulted in both taxpayer burden and potentially billions of dollars in lost revenue to the government. Also, taxpayers continue to be frustrated with their inability to reach IRS by

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[1]P.L. 105-206, July 22, 1998.

[2]IRS' new mission statement reads as follows: "Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all." IRS' supporting strategic goals are to (1) provide top quality service to each taxpayer, (2) provide service to all taxpayers by applying the law with integrity and fairness, and (3) increase productivity by providing a quality work environment for its employees.

[3]IRS Management: Formidable Challenges Confront IRS as It Attempts to Modernize (GAO/T-GGD/AIMD-99-255, July 22, 1999), IRS Restructuring Act: Implementation Under Way but Agency Modernization Important to Success (GAO/T-GGD-00-53, Feb. 2, 2000), and Financial Audit: IRS' Fiscal Year 1999 Financial Statements (GAO/AIMD-00-76, Feb. 29, 2000).

telephone. Once they do get through, taxpayers are further frustrated by IRS employees' inability to quickly and accurately answer questions and resolve problems. Root causes underlying these problems are complex, interrelated, and long-standing and reflect weaknesses in fundamental IRS operations, such as its organizational structure, information systems, performance management system, and human capital management.

- Recognizing the complex and interdependent nature of its long-standing problems, IRS has developed a massive modernization effort—encompassing major changes to its organizational structure, performance management system, information systems, and business practices. About 2 years into a process that will likely take more than a decade, IRS has begun to lay a foundation that should facilitate further changes to IRS' business practices. However, substantial challenges remain in the areas of performance management and information systems modernization. For example, some initial systems modernization work fell well short of expectations, and IRS is trying to get it back on track.

- As Congress recognized in the Clinger-Cohen Act[4], it is best practice to manage long-term modernization efforts incrementally and to measure progress against incremental goals. IRS is following such an incremental approach in implementing its modernization effort and certain areas will be critical to monitor for progress over the next year. These areas include, among others, improvements in enforcement and customer service performance and fulfillment of systems modernization commitments.

IRS Is as Challenged an Agency Now as It Was When the Restructuring Act Was Passed

Given IRS' fragmented, hierarchical organizational structure and antiquated information systems, it is no easy feat that, year after year, IRS is able to process hundreds of millions of tax returns. In fact, despite the potential for complications due to massive Year 2000-related changes, IRS reports that its tax processing systems have processed returns and issued refunds without significant disruptions.

Nevertheless, IRS remains as challenged an agency now as it was almost 2 years ago when the Restructuring Act was passed. As highlighted in the following examples, IRS continues to face serious problems in its two key mission areas—compliance and customer service.

- IRS is struggling with its responsibility to enforce tax laws while it proceeds with its efforts to improve customer service. In reviewing its role as the nation's tax collector, we continue to see instances of taxpayer

[4] P.L. 104-106, February 10, 1996.

burden in which IRS has pursued and collected amounts from taxpayers who were actually due a refund. At the same time, we identified many instances in which accounts that had collection potential were not being actively pursued, thus resulting in potentially billions of dollars in lost revenue to the government. Further, according to IRS data, 1999 collections from delinquent taxpayers were down about $2 billion from 1996 levels. Similarly, comparing pre-Restructuring Act data with 1999 figures, lien filings were down 69 percent, levies were down about 86 percent, and seizures were down about 98 percent. According to IRS, audit coverage for high-income taxpayers[5] has dropped from 2 percent in 1996 to an estimated 0.76 percent for 2000.

- Taxpayers continue to be frustrated with IRS' inability to provide customer service. With respect to telephone customer service, taxpayers have difficulty getting through to IRS by telephone. Although IRS' answer rate for the 2000 filing season was 62 percent as of April 15, 2000, the rate has not reached the 90 to 95 percent level IRS says many private sector companies achieve, much less the 73 percent level IRS achieved in the 1998 filing season. Once taxpayers do get through, they are often frustrated when IRS employees cannot quickly and accurately answer questions and resolve problems.

There is no single cause underlying each of these problems. Instead, root causes are complex, interrelated, and long-standing and reflect weaknesses in fundamental facets of IRS operations, such as its organizational structure, information systems, financial management, performance management, and human capital management.

With respect to its responsibility for enforcing the tax laws, IRS asserts that the recent decline in enforcement activity is due to budget constraints and staff shortages and to a substantial increase in the amount of time required per case caused by provisions of the Restructuring Act. While declining resources and additional requirements imposed by the Restructuring Act may certainly be factors, performance management issues also play a role. In our recent review of IRS' use of seizure authority, for example, we found that neither IRS managers nor front line staff felt that seizure authority was being used when appropriate, and that employees were concerned with the lack of guidance regarding when to make seizures in light of the Restructuring Act.[6] Limitations in IRS'

[5] IRS defines high-income taxpayers as those with taxable income of more than $100,000.

[6] IRS Seizures: Needed for Compliance but Processes for Protecting Taxpayer Rights Have Some Weaknesses (GAO/GGD-00-4, Nov. 29, 1999).

information systems also contribute to difficulties in managing enforcement activities. For example, as a result of system limitations, IRS is unable to promptly identify and focus collection efforts on accounts most likely to prove collectible. System limitations also impede IRS' ability to prevent, detect, or correct errors to taxpayers' accounts. As a result, IRS continues to experience delays in posting activity to taxpayer accounts. These system problems contribute to potentially billions of dollars in lost revenue to the government and undue taxpayer burden.

Similarly, taxpayers' frustrations with respect to customer service stem from several causes. For example, IRS' premodernization structure was organized by function, with different employees responsible for answering taxpayer inquiries, clarifying and correcting tax returns, and collecting unpaid taxes. Since each function maintained separate taxpayer databases, taxpayers were often referred to offices other than those they had initially contacted. Without employees trained to handle taxpayer concerns from beginning to end, and until IRS integrates its stove-piped information systems and creates an accurate and up-to-date taxpayer accounts database, IRS will have a difficult providing top-notch customer service. IRS also lacks important performance data on the results of various efforts to improve customer service. This lack of performance data, coupled with the lack of data on the number of employees that provide customer service and the absence of a supporting cost accounting system, seriously undermines managers' abilities to determine whether various customer service initiatives are, in fact, resulting in quality service at reasonable costs.

Modernization Is Under Way, But Substantial Challenges Remain

Recognizing the complex and interdependent nature of its long-standing problems, IRS has developed an integrated long-term strategy for change to be implemented through a massive modernization effort that encompasses major changes to its organizational structure, performance management system, information systems, and business practices. About 2 years into a process that is likely to take more than a decade to fully implement, IRS has begun to lay a foundation that should facilitate further changes to IRS' business practices. However, substantial challenges remain in the areas of performance management, information systems modernization, and revamped business practices.

Progress Thus Far Is in Laying a Foundation for Further Change

IRS' development of and commitment to an integrated modernization strategy is itself a significant achievement. The Commissioner is actively engaged in all aspects of the modernization effort and is committed to making it successful. We agree with the Commissioner that the success of the modernization effort is contingent upon implementing it in an integrated fashion—something that was missing from previous modernization efforts. IRS has focused much of its initial energy on reorganizing around taxpayer segments, developing a new performance management system, and modernizing information systems.

Reorganization

The reorganization is an important piece of IRS' modernization process. Under IRS' past organizational structure, authority for administering the tax code and serving taxpayers was decentralized to 33 districts and 10 service centers. To better meet its new mission and strategic goals, IRS identified its primary taxpayer segments and the key processes—prefiling, filing, and postfiling—that are to define IRS' primary interactions within each of these segments. IRS is reorganizing around four operating divisions, each with end-to-end responsibility for all of the key processes for their respective taxpayer segment. Teams of IRS employees have developed highly detailed blueprints outlining how each new organizational unit should function. While taxpayers may not notice many tangible benefits from the reorganization itself, we agree with IRS that this streamlined management structure and institutionalized focus on taxpayer segments should facilitate clearer authority and accountability for managers and, as a result, aid IRS in tailoring business practices to taxpayer needs.

Our monitoring work indicates that the reorganization is proceeding reasonably well. The Commissioner has selected executive leadership teams, which combine career IRS employees with outside hires, and IRS is shifting employees to the new organizational structure in phases. Of the four main operating divisions, one is officially up and running and the remaining three are scheduled for start-up this year.[7]

Performance Management

No matter what the strength of IRS' top leadership or its organizational structure, successful modernization ultimately depends on whether the employees who are to lead, manage, and carry out agency programs and services can deliver IRS' new mission. As we have said, an organization's human capital policies, including the performance management system it uses to manage and motivate its people, must be aligned to support its

[7]The four operating divisions and their start-up dates are (1) Tax Exempt and Government Entities, serving pension plans, exempt organizations, and governments (up and running since December 1999); (2) Large and Mid-Size Business, serving businesses with assets over $5 million (June 2000); (3) Wage and Investment Income, serving individual taxpayers with only wage and investment income (October 2000); and (4) Small Business and Self-Employed, serving fully or partially self-employed individuals and small businesses with assets under $5 million (October 2000).

mission and expectations of itself.[8] At the heart of a performance management system is a set of balanced measures that, if properly used, helps organizations assess progress toward achieving strategic goals and improving operations. When aligned with an employee evaluation system, the measures can serve as a powerful tool by creating incentives that encourage employees at all levels to work together toward a common end.

IRS has recognized that a system of balanced measures might help achieve its new mission, and it has become one of the leaders in bringing the concept to the federal sector. In the past, IRS had focused heavily on indicators related to revenue production, and it took steps so that its performance management system supported this emphasis. Over 2 years ago, we highlighted our concerns about overreliance on enforcement revenue as a measure of performance.[9] We concluded that such overreliance could create undesirable incentives for IRS auditors to recommend taxes that would be unlikely to withstand taxpayer challenges, imposing an unfair and unnecessary burden on some taxpayers. To revise its performance management system to better reflect its new mission, IRS is developing a new suite of measures to address three strategic goals: service to each taxpayer, service to all taxpayers, and productivity through a quality work environment. For each strategic goal, IRS is developing a discrete corresponding measure--customer satisfaction, business results, and employee satisfaction, respectively.

Systems Modernization

IRS recognizes that revamping its time-worn tax processing systems is a critical aspect of modernization and has taken several steps toward this end. Specifically, in December 1998, IRS hired a prime contractor to, among other things, assist IRS in completing and updating the modernization blueprint that IRS developed in 1997. This update is to account for changes due to organizational restructuring, new technology, and Restructuring Act requirements. IRS also has developed a business systems plan that outlines a 5-year business modernization strategy, including a listing of priority projects for the next 3 to 5 years. It has also largely developed a systems life cycle process to govern cradle to grave management of its system investments.

[8] Human Capital : A Self Assessment Checklist for Agency Leaders (GAO/GGD-99-179, September 1999) and Human Capital: Key Principles From Nine Private Sector Organizations (GAO/GGD-00-28, Jan. 31, 2000).

[9] Tax Administration: Taxpayer Rights and Burdens During Audits of Their Tax Returns (GAO/T-GGD-97-186, Sept. 26, 1997).

Significant Challenges Lie Ahead

While IRS has made some initial headway in laying the foundation for further modernization, significant challenges lie ahead in three areas. These include: (1) completing all elements of a performance management system; (2) revamping its business practices; and (3) effectively and efficiently building modernized systems, using requisite management and technical controls, to support performance management and revamped business practices.

Completing Key Elements of the Performance Management System

IRS is at risk of failing to achieve the congressional intent behind the Restructuring Act until it implements all the key elements of its revamped performance management system. Two critical parts of this system not yet completed are (1) a full set of balanced performance measures that is based on reliable data and (2) an employee evaluation system that provides employees with a clear line of sight from their performance to the balanced measures. IRS is working to develop both.

While IRS has clearly made progress in implementing balanced measures to serve as the foundation of its revamped performance management system, it is still missing a measure of voluntary compliance. Although it will be difficult to reliably estimate voluntary compliance, such a measure is essential for a number of reasons. Regularly measuring progress in voluntary compliance is important in order to gauge whether IRS is accomplishing a key aspect of its mission. Also, the information about taxpayers to be generated as part of measuring voluntary compliance may help IRS identify the characteristics of taxpayers who have difficulty understanding and meeting their tax responsibilities. Finally, the data IRS would develop as part of any voluntary compliance measurement effort may allow IRS to better direct its enforcement resources to those taxpayers who willfully flaunt the tax laws, thus reducing the burden on compliant taxpayers. IRS recognizes that it needs a reliable and meaningful measure of voluntary compliance and is working with a contractor to determine how to measure compliance with the least burden on taxpayers. However, that effort is still in its early stages.

Regardless of the set of balanced measures that IRS ultimately develops, collecting meaningful, reliable performance data will be difficult given IRS' ongoing problems with data integrity and its lack of a cost accounting system. Until such time as IRS resolves these fundamental data issues and has reliable performance data, it will be difficult to hold managers accountable for their results.

The second critical part of performance management is an employee evaluation system that reflects the agency's mission. Guided by concerns that IRS employees were focused on revenue production rather than service to taxpayers, the Restructuring Act included explicit prohibitions against using enforcement statistics to evaluate employees. IRS now recognizes that employees must have a clear line of sight between their day-to-day activities, their resulting performance evaluations, and the agency's broader goals. IRS is still exploring several different approaches for revising its employee evaluation system to make the relationship between employee performance and agency performance more transparent.[10]

Revamping Business Practices

IRS has started to revamp its business practices to better meet taxpayer needs and improve agency operations. However, implementing business practice changes will not be easy. In the coming years, responsibility for taking a hard look at how IRS can enforce the tax laws and meet customer needs in new and better ways will rest with the new operating divisions. This will be a challenge both in overcoming cultural barriers to "thinking outside the box" as well as in coordinating the requisite human capital, data, and information system support across IRS.

One example of this rethinking is IRS' fresh look at how it provides face-to-face customer service. Based on the conclusion that, from a taxpayer's perspective, a single point of contact for resolving issues is a better way of doing business, IRS is creating a new Tax Resolution Representative (TRR) position. TRRs are to be permanent staff at IRS walk-in sites who perform traditional prefiling duties, such as answering tax law questions and helping taxpayers prepare their returns, as well as postfiling compliance duties, including installment agreements, account adjustments, and simple audits.

The concept of combining prefiling and postfiling service embodied in the TRR position is compelling and fits neatly with IRS' goal to improve service to each taxpayer. As with other business practice changes, however, implementing the TRR concept will require investments in human capital and information systems. Probably the greatest human capital challenge will be training. The initial cross-functional training needs will be significant because the TRR position combines elements from several current positions, and ongoing training to keep such a broad array of skills up-to-date will be a continuing challenge. We also expect that the TRR position will require strong interpersonal skills. In addition

[10] IRS Personnel Administration: Use of Enforcement Statistics in Employee Evaluations (GAO/GGD-99-11, Nov. 30, 1998) and IRS Employee Evaluations: Opportunities to Better Balance Customer Service and Compliance Objectives (GAO/GGD-00-1, Oct. 14, 1999).

to training, TRRs will also need enhanced information system support to do their jobs effectively. For example, providing high-quality service to taxpayers will be difficult without access to an information system that contains accurate and up-to-date information on taxpayer accounts, something that IRS plans to deliver as part of its information systems modernization effort.

Building Modernized Information Systems

Until IRS' antiquated information systems are replaced, they will continue to hinder efforts to manage agency operations and better serve taxpayers through revamped business practices. Unfortunately, IRS' progress over the past year on the systems modernization front has fallen well short of expectations, in large part because IRS did not implement management and technical controls needed to guide the systems modernization process. IRS has recognized that it must first put in place the requisite modernization management capabilities and thus has scaled back its new system projects until it has done so.

Before IRS can actually build modernized systems, it needs to fully implement key controls that are necessary to effectively guide and constrain modernization initiatives. These controls include (1) completing its modernization blueprint; (2) implementing a "systems life cycle" process, including development of business cases, to manage system investments; (3) establishing a fully operational management structure to oversee systems modernization; and (4) clearly defining and implementing IRS and contractor roles and responsibilities.

In a systems modernization expenditure plan submitted to Congress in mid-1999,[11] IRS committed to having selected controls in place by October 1999 and established milestones for progress on individual systems projects. As of March 31, 2000, however, IRS either had not met, or did not yet know whether it had met, most of the commitments that it made in that plan. For example, IRS had committed to full implementation of the systems life cycle process by October 31, 1999, but in March 2000 reported that it still had not completely defined or implemented it. In fact, until only recently, none of the individual systems projects were following the systems life cycle process, because IRS and contractor staff had not been trained in its use. This is important because failure to adhere to the

[11]Pursuant to the fiscal year 1998 Treasury and General Government Appropriations Act (P.L. 105-61) and the fiscal year 1999 Omnibus Consolidated and Emergency Supplemental Appropriations Act (P.L. 105-277), IRS and the Department of the Treasury are required to submit to Congress, for approval, an expenditure plan that meets certain conditions (e.g., implements IRS' Modernization Blueprint and meets IRS system life cycle management program requirements) before IRS can obligate funds for systems modernization.

management and engineering discipline embedded in the process seriously jeopardizes a project's ability to deliver promised capability, on time, and within budget. As of March 31, 2000, IRS had neither completed its modernization blueprint, nor clearly delineated IRS and contractor roles and responsibilities. Also, IRS systems modernization management organization was not fully operational.

Key Indicators for Gauging IRS' Progress in the Coming Year

As Congress recognized in the Clinger-Cohen Act, it is best practice to manage long-term modernization efforts incrementally and measure progress against incremental goals. IRS is following an incremental approach in implementing its modernization effort and below are a few areas that will be critical to monitor for progress over the next year.

- <u>Improved performance in enforcement and customer service functions:</u> Specifically, the Commissioner has said that he expects to see a reversal in the downward trend in enforcement statistics. In terms of customer service, taxpayers' ability to reach IRS by telephone should improve in the 2001 filing season because IRS plans to spend some of its systems modernization funds for a project that is designed to increase the telephone answer rate. IRS expects to finalize its estimate of the expected level of improvement from this project, as well as its cost, in early May 2000.

- <u>Progress in developing a measure of voluntary compliance:</u> While it may take several years to develop reliable estimates of voluntary compliance, it will be important for IRS to define the measure and develop a strategy for obtaining the necessary data for such a measure. Doing so will provide stakeholders with an opportunity to begin a dialogue of how best to obtain data without placing an undue burden on taxpayers.

- <u>Incremental implementation of a new employee evaluation system:</u> For IRS employees to have a clear line of sight to IRS' new mission, IRS needs to stay on track for implementing a new employee evaluation system. IRS hopes to implement some aspects of the new system for 60 percent of its bargaining unit employees in October 1, 2000. In July 2000, IRS expects to begin efforts to apply aspects of the new systems to other employees who comprise another 20 percent of IRS' bargaining unit employees.

- <u>Satisfaction of systems modernization commitments:</u> IRS' March 7, 2000, spending plan specifies a number of commitments, such as implementation of its systems life cycle process by June 30, 2000, and development of an updated modernization blueprint by September 30, 2000. Per our recommendation in June 1999, IRS' next systems modernization expenditure plan should fully disclose IRS' progress in meeting these commitments.[12]

- Improvements in basic internal controls: In addition to making incremental progress toward long-term modernization goals, improvements in basic internal controls and processes during fiscal years 2000 and 2001 should occur. Such controls include prohibiting employees from handling receipts and taxpayer data until their background checks are satisfactorily completed, and properly accounting for property acquisitions and dispositions.

Mr. Chairman, this concludes our prepared statement. We would be happy to answer any questions you or other Members may have.

Contacts and Acknowledgments

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[12] Tax Systems Modernization: Results of Review of IRS' Initial Expenditure Plan (GAO/AIMD/GGD-99-206, June 15, 1999).

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